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In the

Supreme Court of the United States

OCTOBER TERM, [redacted] 1969

NORTHEASTERN CONSOLIDATED COMPANY,
Petitioner,

vs.

UNITED STATES OF AMERICA

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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Paul A. Teschner, Esq., on behalf of Northeastern Consolidated Company (hereinafter "Taxpayer"), a Delaware corporation, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Seventh Circuit in this case.

OPINIONS BELOW

The majority (App. A, 1a-5a)[1] and dissenting (App. B, 6a-9a) Opinions of the Court of Appeals are reported

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[1] "App." references are to the Appendix to this Petition.

at 406 F.2d 76 at 77 and 79 respectively. The opinion of the District Court (App. C, 10a-19a) is reported at 279 F.Supp. 592.

JURISDICTION

The majority and dissenting opinions of the Court of Appeals were filed on January 6, 1969. Rehearing en banc was denied on February 17, 1969. The jurisdiction of this Court is invoked under 28 USC 1254(1).

QUESTIONS PRESENTED

(1) Whether, as the majority of the Panel below held, advances made by a corporate taxpayer to another corporation ("NECCO") in which it owned no stock were "investments" because those advances bore no interest, had no definite maturity date, were unsupported by security, and were made to a "thinly-capitalized" corporation; or whether, as the Sixth Circuit and the Court of Claims have held, there being no contrary cases, such advances upon becoming worthless were deductions against the taxpayer's ordinary income because when made they were proximately related to the taxpayer's own business.

(2) Whether, as the majority of the Panel below held, those advances-become-investments were "capital assets" so that the taxpayer's loss was a capital loss only; or whether, consistent with this Court's decision in *Corn Products Refining Co.* v. *Commissioner*, 350 U.S. 46, such advances even after transmutation into "investments" were non-capital assets because proximately related to the taxpayer's own business.

(3) Whether those re-structured advances were capital "equity investment" but not stock, as the majority of the Panel held; or whether, as Taxpayer contends, that fic-

tional equity capital investment must necessarily have been stock so that Taxpayer's resultant capital loss would nevertheless have been deductible in full against its ordinary income within the intent and purpose of the affiliated corporation loss provisions of Section 165(g)(3) of the Internal Revenue Code of 1954.

STATUTES INVOLVED

Appendix D (App. 20a-22a) sets forth the provisions of Sections 162, 165, 166, 1011 and 1012 of the Internal Revenue Code of 1954 which are relevant to the decision of this case. Upon Taxpayer's return as originally filed the unpaid advances were deducted as "bad debts" under Section 166. After a deficiency was assessed and paid, a claim for refund was filed which asserted that "* * * said amount of $199,791.09 was authorized as a deduction * * * by Section 162 and/or Section 165 and/or Section 166 * * * and by the general common law of and governing Federal income taxation." (R. 13). The majority of the Panel rejected the deduction upon any of the alternative grounds.

STATEMENT

Consolidated Gas and Service Company (hereinafter "Taxpayer") was incorporated on April 9, 1949, under the laws of the State of Delaware. From the date of its incorporation until April 1, 1956, all of Taxpayer's capital stock was owned by John C. Donnelly (R. 23).[2] On April 1, 1956, Taxpayer changed its name from Consolidated Gas and Service Company to Northeastern Consolidated Company (R. 16).

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[2] "R." references are to the Appendix filed in the Court of Appeals.

Taxpayer was a utility contractor (R. 77) and at first was engaged principally in the construction of gas mains and other facilities used in the transmission of natural gas (R. 58, 73). Although Taxpayer initially worked in the Wisconsin area, at all times relevant to this case its activities were limited almost entirely to construction work in upper New York State (R. 58).

In 1954 the development of the St. Lawrence Seaway Project in Upper New York State was responsible for a major demand for construction of electric power lines and other electrical facilities (R. 80). One of Taxpayer's good customers had been Niagara Mohawk Power Company ("Niagara Mohawk") and in 1954 that Company was allocating considerably more funds for electrical construction than for gas main construction (R. 60-61). Since Taxpayer had succeeded in cutting costs considerably upon the gas utility construction work which it had done for Niagara Mohawk (R. 84), Taxpayer was urged to bid upon the construction of Niagara Mohawk's proposed electrical facilities (R. 75, 77, 84). Wincent Hecht, Operating Vice President of Taxpayer in charge of field operations (R. 71, 88, 91, 95) received a "very firm conviction" (R. 88) that if he did not accede and bid the electrical projects, then Taxpayer would be in substantial danger of losing the Niagara Mohawk gas construction business also (R. 85-86). The proposal for Taxpayer to bid the electrical construction jobs appealed to Hecht, however, because the gas construction business was seasonal (R. 76) with long periods of winter inactivity (R. 93); also, Taxpayer would be able to use its seasonally-idle equipment, with minor variations and additives, upon the electrical construction jobs (R. 77).

Before Taxpayer could be placed upon Niagara Mohawk's bid list for electrical construction work, it was necessary for it to be "in harmony with the trades." (R.

103). In Upper New York State, this meant that Taxpayer had to be in harmony with the International Brotherhood of Electrical Workers ("I.B.E.W."). Since Taxpayer did not have employees who belonged to the I.B.E.W. (R. 63), and since Taxpayer could not have performed electrical construction contracts for Niagara Mohawk or anyone else without having electricians as employees (R. 86), a condition precedent to Taxpayer's performance of electric utility construction work was to harmonize itself with the I.B.E.W.

Unfortunately, the I.B.E.W. had a firm policy against entering into contracts with contractors who did not devote themselves exclusively to electric construction activities (R. 78). To Daniel Evans, at that time a member of the Executive Council of Local 1249, I.B.E.W. (R. 95), the reason for this restrictive policy was clear: "It's quite obvious. I mean if every general contractor would have an electric agreement, there would be no electrical contractors. That is the primary function of the purpose of the I.B.E.W. is to work with electrical contractors." (R. 99). And in response to a question as to whether Taxpayer could have obtained an agreement with the I.B.E.W., Mr. Evans testified: "No, I wouldn't think so. It would have been virtually impossible. • • • [I]t wasn't a policy for the I.B.E.W. to grant agreements with general contractors or contractors in allied business or—well, I just don't think that they would have any occasion to give an agreement with the [Taxpayer] Company." (R. 97, 99-100).

Notwithstanding Mr. Evans' somewhat equivocal assertion that it would have been "virtually impossible" for Taxpayer to have secured an agreement with the I.B.E.W., Mr. Hecht graphically described his diligent but unsuccessful efforts to do just that (R. 77-79):

"Q. And what happened after that? [i.e., after someone from Niagara Mohawk had approached Taxpayer about constructing electric facilities].
"A. I called Donnelly [the then President of Taxpayer (R. 61)] and he was hesitant and he said go ahead. So there is a clause in Niagara Mohawk's agreement 'you must be in harmony with the trade.' This is in their basic specification in the contract with that respective trade. So I approached 1249 Local 1249 and asked to get a contract. They said we'll not give you a contract because you are a general contractor. I refuted that statement and said I was a utility contractor and there is a difference. We were not in the business of building homes or warehouses or any other types of structure exclusive of that which was associated with gas lines or utility work, manholes. We use concrete, we use concrete for sidewalk replacement, etc., etc., etc.; • • •

• • •

"So I met with Ed Peck of 1249 and said I wanted a union contract. I wanted to abide by Niagara Mohawk's rules. He stated no, we'll not give you a contract, you are a general contractor and it is our policy —I can't quote those words exactly, but the intent is our policy is just to give contracts to those only engaged in electric construction. I gave him many instances of names of people that I knew that were in combined type of operations • • •. He said those had Grandfather Rights so I approached it from the point of going into the International knowing they had International contracts. I explored that position. The International said they wouldn't give me a contract unless the Local Union agreed. From that point, we explored all other means and they were very adamant about it. They were not under any circumstances giving us a contract under Consolidated Gas and Service Company.
"Q. Well, you didn't give up that point, did you?
"A. I never give up. There is no such choice.

"Q. What happened after that then?
"A. So I discussed it with Donnelly and Donnelly said as long as we are in it this deep and we've spent this much money, what other area do you have? And I said well, why don't you just form a separate corporation paper-wise just for the purpose of acquiescing, if that might be the word, to their demands, and it will just be a paper idea and use the same equipment, normally the same man-power and we would get a contract through because at that time the Power Authority thing was just breaking. Niagara Mohawk had an ocean of work that was in the bidding stage and I was at my wits end trying to figure out the quickest way of getting a contract, and this seemed the only logical solution, but I wish it never happened. Don't put that in."

Mr. Hecht then reported the results of his efforts to the principal officers of the Taxpayer and a decision was made to organize a separate corporation to obviate the objections of the I.B.E.W. (R. 58-59, 62-63). The only reason for the establishment of the "paper corporation" was to overcome the I.B.E.W. refusal to allow Taxpayer to employ electricians and bid electrical construction contracts directly (R. 88).

On November 3, 1954, Northeasten Electric Construction Corporation ("NECCO") was incorporated under the laws of the State of Delaware (R. 23); NECCO was capitalized with an earned surplus of $8,358.11 and a capital stock account of $4,000 (R. 24); 400 shares of capital stock were issued by NECCO which were distributed 300 shares to Taxpayer's President John C. Donnelly (R. 61) and 100 shares to its Secretary (R. 58) Arthur W. Schmidt (R. 24). This represented a total initial capitalization of $12,358.11. Taxpayer did not then nor did it subsequently own any shares of NECCO (R. 24).

Before NECCO could engage in any electric construction work, it had to obtain an agreement with the I.B.E.W., but the Union Executive Committee knew that "* * * NECCO was just a name" at the time it applied for an agreement with the I.B.E.W. (R. 97). One of the factors which was normally taken into consideration by the Executive Committee when a contractor applied for I.B.E.W. approval was the financial status of the applicant (R. 97-98). When NECCO applied for an agreement with the I.B.E.W. its application was supported by the financial statements of Taxpayer (R. 96-97). Another factor considered by the union Executive Committee in considering a contract with NECCO was the good likelihood of electrical construction work being procured because of the excellent relationship of Taxpayer to Niagara Mohawk (R. 98). Thereupon, and notwithstanding the contractual requirement that no employer was qualified to receive an I.B.E.W. agreement who did not have "knowledge, experience and financial responsibility" and who was not "maintaining a permanent place of business" (R. 53), a contract was entered into between NECCO and the I.B.E.W. (R. 51-55).

Niagara Mohawk had its own prerequisites for a contractor to be placed upon its bidding list for electrical construction work in addition to the "harmony with the union" requirement; financial soundness, a good reputation, and proper equipment were all conditions precedent to being placed on a bidding list. (R. 102). It was Taxpayer, not NECCO, who satisfied those requirements (R. 102-103). Niagara Mohawk did not even compel NECCO to submit financial statements or to comply with any other requirement because of the fact that it "had done enough business with Consolidated Gas [Taxpayer] to know they were sound in our estimation." (R. 103).

Before NECCO could obtain contracts to perform electrical construction work, it was required to obtain surety bonds guaranteeing its performance (R. 24). The credit of NECCO was not good enough for the Surety Company (R. 25, 68) with the result that with regard to each application submitted by NECCO the Surety Company refused to issue a bond without security (R. 25). Security was therefore supplied upon all of the required bonds by Taxpayer who agreed to indemnify the Surety Company against loss on NECCO's performance bonds (R. 25). Taxpayer received no security from NECCO as consideration for acting as indemnitor and no written agreement was entered into between Taxpayer and NECCO pertaining to Taxpayer's agreement to indemnify the Surety Company (R. 26).

Taxpayer never guaranteed any obligation of any other business entity except NECCO (R. 72); the reason for Taxpayer's agreement to act as indemnitor was so that NECCO could proceed with electric construction contracts (R. 68).

NECCO did not have separate offices but rather used the offices of Taxpayer (R. 71). The only employees of NECCO were the electrician members of the I.B.E.W.; and all other workers on the electric construction jobs were employees of Taxpayer (R. 83-84). It was Taxpayer's equipment, not NECCO's, which was used on all the electric construction projects (R. 87). Employees of Taxpayer directed (R. 81-88), superintended (R. 89-91), and supervised (R. 92-94) the electric construction projects. Indeed, NECCO was regarded by supervisory employees as being the "Electrical Department" of Taxpayer (R. 90).

The electrical construction projects were not successful. The members of the I.B.E.W. did not accept instructions from Taxpayer's supervisory employees on the electric construction jobs (R. 90), the I.B.E.W. workers failed to cooperate with Taxpayer (R. 82), and there was a tendency of the I.B.E.W. to compel Taxpayer to use "* * * derelict type man-power" upon the electric construction jobs (R. 83).

In a number of instances Taxpayer received requests from the sureties to advance funds to NECCO for construction purposes in order to avoid action of the sureties against Taxpayer based upon the guarantees and the indemnifying agreement which Taxpayer had executed (R. 38, 47-48). Between December 30, 1954 and February 28, 1956, Taxpayer made sundry advances either directly to or on behalf of NECCO (R. 26, 35-36); as NECCO needed funds for payroll, payment for construction materials, etc., Taxpayer would make advances to NECCO (R. 65-66) which would then use the advances to meet its operating expenses (R. 29).

The advances which Taxpayer made to or on behalf of NECCO at the request of the sureties on the performance bonds had no maturity dates, were made without security, were not reflected by any written evidences of indebtedness, and bore no interest (R. 28-29). The advances from Taxpayer to and for the benefit of NECCO were shown as accounts receivable upon the books of account of Taxpayer and as accounts payable upon the books of account of NECCO (R. 44-45).

On February 29, 1956, NECCO's books of account reflected a current liability due Taxpayer of $327,677.31 and Taxpayer's books of account disclosed a current account receivable of the same amount owing it from

NECCO (R. 44-45). A corporation was organized in New Jersey to perform only gas utility construction work which thereby freed Taxpayer to limit itself to the direct performance of electric utility construction activities (R. 69-72). Special meetings of the Directors of Taxpayer (R. 37-46) and NECCO (R. 46-51) were held on March 23, 1956 to consider the NECCO situation. Pursuant to resolutions duly adopted at those meetings, an "Agreement of Merger" was entered into between Taxpayer and NECCO; the purpose of that Agreement was to reduce Taxpayer's losses from the electric construction activities (R. 38, 48).

On March 31, 1956, the merger was effectuated; Taxpayer thereupon claimed a deduction of $199,791.09 to account for the insufficiency of the net assets of NECCO upon its liquidation and merger to satisfy the advances which Taxpayer had made to it. It is that amount of $199,791.09 claimed by Taxpayer as a deduction upon its Federal income tax return for its taxable year ended March 31, 1956, which eventuated in this case (R. 28).

Subsequently the District Director of Internal Revenue assessed timely deficiencies in income tax and interest against the Taxpayer based upon a disallowance to Taxpayer of the $199,791.09 deduction claimed (R. 18). Thereafter, Taxpayer timely filed claims for refund of those amounts plus interest (R. 19). After receiving notices of disallowance of those claims (R. 19), Taxpayer filed suit for refund in the United States District Court for the Northern District of Illinois; the basis for Federal jurisdiction of the District Court was 28 U.S.C. § 1346(a)(1). The case was fully stipulated and there was no trial. The District Court's decision (App. C, 10a-19a) in favor of the United States is reported at 279 F.Supp. 592.

On appeal by the Taxpayer, the Court of Appeals for the Seventh Circuit affirmed in a divided opinion which is reported at 406 F.2d 76. The opinion of the majority of the Panel appears herein at Appendix A (App. 1a-5a) and the opinion of Judge Swygert, dissenting, is reported herein at Appendix B (App. 6a-9a).

REASONS FOR GRANTING THE WRIT

(1) The Court of Appeals has rendered a decision in conflict with decisions of the Court of Appeals for the Sixth Circuit and the Court of Claims upon the same matter. The question is whether advances proximately related to a corporate taxpayer's own business activities will, upon becoming worthless, justify an ordinary deduction; or whether only a capital deduction will be proper because the advances lack the characteristics of "bona fide" debt, such as interest, security, and a definite maturity date.

Judge Swygert's dissenting opinion was based almost entirely upon the case of *Byerlite Corporation* v. *Williams,* 286 F.2d 285 (6th Cir. 1960). Since Judge Swygert's opinion draws the parallel between this case and the *Byerlite* case with remarkable clarity, it is respectfully incorporated herein by reference (App. B, 6a-9a, 406 F.2d 76 at 79-81).

In *American Processing & Sales Company* v. *United States,* 371 F.2d 842, the Court of Claims followed the *Byerlite* case and in the process of doing so emphasized that the debtor corporation had been organized for a good business purpose of taxpayer, to wit, an attempt by the taxpayer to preclude a union organizing drive [371 F.2d 842 at 850-851]:

"Similarly, the mere fact that the incorporation of Mellody [cf. NECCO] was not ultimately responsible for producing the desired results of defeating the union's efforts does not diminish the fact that defeat of the union's efforts was nevertheless the motivating purpose for the incorporation. That purpose was essentially a *business* purpose, for the plaintiff [taxpayer] naturally considered that continuation of the exemption of the Farms Divisions' agricultural labor from the NLRA would be vital to its economic future.

"From the standpoint of timing, the incorporation of Mellody [cf. NECCO] coincided with the labor union's efforts, and to attribute its purpose to tax avoidance is to overlook certain realities of the situation. Mellody was formed to make profits, not to incur losses. * * * Had Mellody continued its operations as an unincorporated division of the plaintiff company, its losses would have been offset against plaintiff's ample income. * * * If we accept the conclusion that frustration of the unionization drive was the plaintiff's prime goal in incorporating Mellody, and in furtherance of that end Mellody was financed in a manner of plaintiff's devising, when the Commissioner later smelled a different purpose and construed plaintiff's open account advances to Mellody to be capital contributions rather than the loans they were intended by the parties to be, then it is the Commissioner who deliberately choose to cast the plaintiff's transactions in a mold different from the taxpayer's intention. In short, I do not believe the facts warrant a finding in this instance that a tax tail wagged a labor dog."

Here also NECCO was organized solely to advance Taxpayer's own business interests and at all subsequent times it was a mere adjunct to Taxpayer's own business activities whereby Taxpayer devoted its own equipment, employees and credit, and, ultimately, its money—to the electric utility construction projects.

Both *Byerlite* and *American Processing* were decided unanimously in favor of taxpayers, the Sixth Circuit *Byerlite* case by Chief Judge McAllister for himself and Judges Pope and Thornton, the *American Processing* case by a *per curiam* decision of all of the seven Judges of that Court. Considering *Byerlite, American Processing,* and this case together, therefore, there has been a vote upon the common question of 11-2 in favor of the taxpayers.

(2) The majority of the Panel of the Court of Appeals has decided the important Federal tax question of whether an asset is a capital asset in a way in conflict with the decision of this Court in *Corn Products Refining Co.* v. *Commissioner,* 350 U.S. 46 (1955).

The majority below reached a result in conflict with *Corn Products* by holding that the advances made by Taxpayer to NECCO, treated as loans on the books of both corporations, constituted an "investment" which, in turn, was a "capital asset." No inquiry was made as to how NECCO differed from corporations, like General Motors and A.T.&T., in which taxpayers normally make capital investments.

Corn Products is usually cited to support the general rule that an asset will not constitute a capital asset if it arises from the everyday operations of a business; somewhat refined, the theory is that any asset which is an integral component of a taxpayer's own business operations does not constitute a capital asset. As Judge Swygert pointed out in his dissenting opinion below, the advances by Taxpayer to NECCO were all proximately related to Taxpayer's own business. Although Judge Swygert was talking of that proximate relationship in

reference to the propriety of the deductions, that same proximate relationship would preclude the advances, even after characterization as "investments", from being classified as "capital assets."

An unbroken line of decision of other Courts of Appeals and of the Court of Claims; both before and after this Court's *Corn Products* case, have held that even direct stock investments by a taxpayer do not constitute capital assets if they are made in the ordinary course of the taxpayer's own business activities. See, for example, *Five Star Manufacturing Company* v. *Commissioner,* 355 F.2d 724 at 727 (5th Cir. 1966) ("it can scarcely be held that the payment * * * was for the acquisition of a capital asset, but rather one which would permit Five Star again to use assets for income production by freeing its management from unwarranted fetters. * * *"); *Booth Newspapers, Inc.* v. *United States,* 303 F.2d 916 at 921 (Ct. Cl. 1962) ("Given the condition prevalent in the newspaper market at the time and the difficulties plaintiffs experienced with respect to the conduct of their normal business operations, the acquisition of Michigan was an eminently reasonable expedient for them to follow. The difficulty with defendant's position is simply that the record will not support a conclusion that plaintiffs were investment-minded when they purchased the stock * * *."); *Lutz* v. *Commissioner,* 282 F.2d 614 at 619 (5th Cir. 1960) ("the corporation [whose debts were paid by the taxpayer] had little property to which they held record title, which might serve as the basis for credit independent of that derived from petitioner's connection with them and his participation in their management as in former years and his backing, with his own credit, a large portion of the transactions which constituted the bases of the expense deductions here."); *United Gas Improvement Com-*

pany v. *Commissioner*, 240 F.2d 312 at 317 (3d Cir. 1956) ("[I]n the case of each advance, a letter agreement was entered into under which the taxpayer was to be repaid the advances if and when the Securities Company [cf. NECCO] realized earnings in excess of its current preferred stock dividend requirements. The possibility of such reimbursement, which existed as long as the Securities Company remained a going concern, was cut off by its liquidation. • • • We agree with the • • • Fourth Circuit • • • that "a loan is no less a loan because its repayment is made contingent • • • and a taxpayer has no right to treat it as a loss until the contingency has occurred or its worthlessness has been otherwise determined.' • • •"); *Commissioner* v. *Bagley & Sewall Co.*, 221 F. 2d 944 at 947 (2d Cir. 1955) ("We find no comparable authority wherein a contract is dissected and its separate parts are subjected to application of particular sections of the Revenue Law. The Tax Court was right in refusing to wrench this transaction from its setting and its finding and conclusion is amply supported by evidence. To cite otherwise is to apply the law so as to escape reality."); *Daily Journal Co.* v. *Commissioner*, 135 F.2d 687 at 688 (9th Cir. 1943) ("In no sense can we consider Petitioner • • • as a mere passive investor. • • • [P]etitioner's managerial activities in Consolidated were 'extensive, varied, continuous and regular'. An expensive publishing business was carried on by agreement, not a mere doing of 'only what is necessary from an investment point of view.' • • •").

Taxpayer intended to earn profits in the construction of electric utility facilities, not to incur losses. If Taxpayer's intent had been realized one may query whether—had Taxpayer then sold its "investment" in NECCO—the Commissioner would have accepted a reporting of those

anticipated profits at capital gain rates as a sufficient discharge of Taxpayer's tax liabilities. In that circumstance, it is fairly predictable that the Commissioner would rely upon the holding of *Corn Products* and determine that Taxpayer's advances to NECCO did not constitute capital assets.

(*3*) The Court of Appeals has decided an important question of Federal tax law which has not been, but should be, settled by this Court. That question is the extent to which, if any, taxpayer volition is a factor of at least residual relevancy in Federal income tax cases. In this particular case, NECCO was formed for the sole purpose of satisfying the I.B.E.W. requirements and for no other purpose (R. 88) and Taxpayer had no choice to do otherwise except to desist from its attempt to preserve and expand its own business by undertaking electrical construction activities.

The statutory context in which the volition question should be decided here is whether the re-constructed advances which the majority fictionalized into "equity investment" [406 F.2d 76 at 79] would constitute "stock" so that Taxpayer would have been entitled to an ordinary loss deduction under the special loss provisions of Section 165(g)(3) of the 1954 Code. If Taxpayer had been well advised and sophisticated tax-wise, it would never have gotten into its present predicament for if it had consciously purchased stock in NECCO in the amount of the advances, then it would clearly have been entitled to an ordinary deduction under Section 165(g)(3). Upon this point, the Commissioner's position here is really quite shocking for he is saying: "Let's look through this situation but let's look only a little way through it, just far enough to maximize Taxpayer's liability for Federal income taxes."

The majority below rejected the relevancy of the Eighth Circuit case of *Cherry-Burrell Corporation* v. *United States,* 367 F. 2d 669. There the taxpayer had failed to distribute its subsidiary's assets to itself within three years after the close of the first taxable year during which the first liquidating distribution was made, as required by the applicable statute. The Commissioner argued that this failure prevented a tax-free liquidation because of the taxpayer's failure to comply with the statutory mandate. The Eighth Circuit disagreed; noting that there appeared to be "little helpful precedent", the Court rejected the Commissioner's argument that taxpayer volition was irrelevant [367 F.2d 669 at 676]:

> "Only the barrier of the English law prevented what is, at most, technical compliance with the statute's requirements. We are not inclined to impose a forfeiture of tax consequences because of this. If there was non-compliance here, the situation is one of excusable non-compliance and one which fits the maxim *lex non cogit ad impossibilia.* There is more here than the taxpayer's mere inconvenience, as the government suggests."

Another aspect of the majority's elevation of form over substance is its rejection of the Second Circuit's substance-of-the-transaction principle: "* * * [T]ransactions delimited by an overall plan must be characterized for tax purposes from a comparison of the situation as it existed before the first step of the transaction with the situation existing after the last step of the transaction * * *." *South Bay Corporation* v. *Commissioner,* 345 F.2d 698 at 705. Consistent with that principle, the Tax Court recently disregarded a *voluntary* creation of a corporate entity which was "* * * [T]axwise merely a meaningless detour along the highway of redemption of the minority

interest in Old Casco. * * *" *Casco Products Corporation* v. *Commissioner,* 49 TC 32 at 36. Here too, NECCO was merely a detour along the path of Taxpayer's attempt to preserve and expand its own business interests.

Questions relating to substance or form and overall taxpayer transactional purpose are all related to the question of "fairness" to a taxpayer. Without respect to legality, the majority's decision is not a fair one since it disallows a deduction of about $200,000 which a taxpayer spent in an attempt to preserve and increase its own business interests; if the attempt had been successful, the earnings would have been taxed at ordinary income tax rates. Although fairness by itself would not be a proper basis for this Court to exercise its discretionary power of review, it is an important final ingredient when it arises in a case involving a fundamental conflict between different Courts of Appeals and the Court of Claims as well as a disregard of a prior decision of this Court. The Court has remarked at least once that a "common sense estimate of fairness" should be used to interpret a statute. *Morrison* v. *California,* 249 U.S. 82 at 91. Mr. Justice Stone admonished: "Taxation is an intensely practical matter and laws in respect of it should be construed and applied with a view of avoiding, so far as possible, unjust and oppressive consequences." *Farmers' Loan and Trust Company* v. *Minnesota,* 280 U.S. 204 at 212.

This is not a case where the uneven exaction of a tax has been legislatively compelled since Congress has never elevated form over substance in taxation. Dissenting Judge Swygert correctly defined the issue as being whether expenditures proximately related to a taxpayer's own business are deductible *even if* they fall short of the form in which more sophisticated taxpayers cast their transactions. Unanimous, affirmative answers to that question also have been given by the Sixth Circuit and the Court of Claims in the only other two cases found involving the question. If there are humanistic principles supporting the law of Federal income taxation, plenary review will reveal them.

CONCLUSION

The Petition For A Writ Of Certiorari should be granted.

Respectfully submitted,

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MAY 1969

APPENDIX A

OPINION OF THE MAJORITY OF THE PANEL OF THE COURT OF APPEALS FOR THE SEVENTH CIRCUIT

[406 F.2d 76]

Before CASTLE, *Chief Judge,* and SWYGERT and KERNER, *Circuit Judges.*

CASTLE, *Chief Judge.*

This is an appeal from the district court's judgment for the defendant, the United States, rendered in the plaintiff-taxpayer's suit for refund of income taxes, plus interest, for the fiscal years ended March 31, 1954 and March 31, 1955 in the respective amounts of $10.75 and $56,784.95. The controversy stems from the Commissioner's disallowance of taxpayer's deductions for the alleged bad debts of an allegedly related corporation upon the merger of the taxpayer with that corporation.

A brief look at the transactions leading up to this suit, as adduced in the district court, is necessary. The taxpayer was originally organized in 1949 as a Delaware corporation, under the name of Consolidated Gas and Service Company (Delaware Consolidated). The entire capital stock of this corporation, which engaged in the construction of gas distribution facilities, was owned by John C. Donnelly.

In 1954, Niagara Mohawk Power Company, one of Delaware Consolidated's most important customers, became involved in the St. Lawrence Seaway Project and began to allocate considerably more funds for the electrical facilities needed for that Project than for the construction of gas facilities. In order to accommodate this customer, as well as to enter the electrical construction field, a separate company, Northeastern Construction

Corp. (Necco) was organized with Donnelly and Arthur Schmidt, an officer of Delaware Consolidated as its only shareholders. The separate company was formed because the rules of the International Brotherhood of Electrical Workers prevented its members from being employed by companies not doing electrical work exclusively.

Thus, NECCO was formed, with initial capital of only $12,358.11, in order to engage exclusively in the construction of electrical facilities. Because of this thin capital base, Delaware Consolidated advanced over $300,000 to or on behalf of NECCO, primarily for operating expenses. These advances were carried as current liabilities by NECCO and as current accounts receivable by Delaware Consolidated. No written evidences of indebtedness were given, no interest or maturity date was agreed upon and no security was provided.

The NECCO venture proved unprofitable from the beginning, however, and in March, 1956, it was decided to merge NECCO with Delaware Consolidated to form the present taxpayer corporation, Northeastern Consolidated Company. After the statutory merger, under Delaware law, was completed, including a transfer of NECCO's assets to taxpayer, there remained as unpaid balances the amount of $199,791.09, representing the advances to NECCO which were unreimbursed.

Taxpayer then cancelled this amount on its books as a bad debt and deducted it from ordinary income for the fiscal year which ended March 31, 1956. The Commissioner first allowed the deduction and carryback, but subsequently disallowed it and assessed deficiencies. As part of the merger effected in 1956, NECCO's own operating loss of about $187,000 was made available to taxpayer to be offset against its available income under 26 U.S.C. § 381(a) and (c). Taxpayer claimed and was allowed deductions by virtue of this for 1959, 1960, and 1961, in an aggregate amount of approximately $85,000.

The primary issue is whether the Commissioner's disallowance of the bad debt deduction against ordinary

income was proper. This disallowance, as well as the Government's case before the district court and on appeal, is based on the assertion that the advances to NECCO were contributions to capital, rather than loans, and thus the losses incurred were capital losses which could be deducted only from capital gains, of which there were none in the relevant years.

The district court, in a thorough and well-reasoned opinion, 279 F.Supp. 592 (N.D.Ill. 1967), found that the advances constituted contributions to the capital of NECCO rather than loans, and therefore could not be allowed as a bad-debt under 26 U.S.C. § 166. This finding was based on the following factors:

(1) The heavy preponderance of "debt" to equity ($300,000 to $12,000);

(2) The fact that the repayment of the advances rested solely on the success of NECCO's venture;

(3) Plaintiff's own assertions that the activities of NECCO were really part of plaintiff's own business and that they were not a separate corporate venture;

(4) The unlikeliness that NECCO could have obtained $300,000 from any other source on the same terms, or absence of terms, as it received from plaintiff. 279 F.Supp. at 595-96.

We agree with the district court and adopt its opinion on the issue. We find that this conclusion is compelled by looking at the substance, rather than the form, of the transactions.

Similarly, we adopt the opinion of the district court in its holding that the deduction was not allowable as an ordinary and necessary business expense under Section 162, and that it was not allowable as a business loss under Section 165. 279 F.Supp. at 597. On this last point, however, we feel that some further elaboration is necessary.

Taxpayer contends that, even if the advances to NECCO constitute an investment, Section 165[1] allows a deduction against ordinary income for the uncompensated loss suffered on the investment. The real problem taxpayer faces in this area is in showing that its investment in NECCO was not a capital asset and therefore that the loss can be deducted from ordinary income. Taxpayer's first argument on this point is that, although securities in other corporations ordinarily constitute capital assets, the instant security was purchased in the ordinary course of business and was therefore entitled to non-capital treatment. We agree with and adopt the district court's holding rejecting this contention on the grounds that the creation of NECCO as a separate entity, engaged in unrelated work, was not done in the ordinary course of taxpayer's business.

Taxpayer further attempts to bring its investment under non-capital treatment by arguing that the transaction falls under Section 165(g)(3), which provides that any security of a corporation affiliated with the tax-

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[1] § 165 Losses.

(a) General rule.

There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

* * *

(f) Capital losses.

Losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in sections 1211 and 1212.

(g) Worthless securities.

(1) General rule.

If any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall, for purposes of this subtitle, be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.

* * *

payer shall not be treated as a capital asset. This argument fails, however, for two reasons.

First of all, in order to fall under Section 165(g) so as to be treated as non-capital assets, the securities held by the taxpayer must become "worthless." We find that the security held by the taxpayer in the instant case did not become "worthless," but was only impaired to the extent of the loss suffered when the merger took place. See 5 Mertens 28.65b and 28.66. Thus looking at the substance of the transaction, taxpayer invested over $300,000 in NECCO and, on NECCO's merger with taxpayer, received back $192,852. Therefore, although taxpayer took a loss on its investment in the equity of NECCO, its security did not become "worthless", as required by the statute.

[6] Secondly, even under plaintiff's reasoning, NECCO does not qualify as an affiliated corporation. Under § 165(g)(3)(A), "a corporation shall be treated as affiliated with the taxpayer only if — (A) at least 95 percent of each class of its stock is owned directly by the taxpayer * * *" In the instant case, although taxpayer owned an equity investment in NECCO, that investment was not in NECCO's common stock. It is undisputed that Donnelly and Schmidt owned 100 percent of that class and thus NECCO was not, under the statutory definition, affiliated with taxpayer since taxpayer did not own at least 95 percent of each class.

For the foregoing reasons the judgment below is affirmed.

AFFIRMED.

APPENDIX B

OPINION OF CIRCUIT JUDGE SWYGERT DISSENTING FROM THE MAJORITY OPINION

[406 F.2d 76 at 79]

SWYGERT, *Circuit Judge* (dissenting)

In my opinion, the taxpayer, Northeastern Consolidated Company, correctly claimed as a deduction upon its federal income tax return for the taxable year ended March 31, 1956, the $199,791.09 item which represented the unpaid balance of advance made by the taxpayer to Northeastern Electric Construction Corporation (NECCO).

Although the majority's application of the relevant Revenue Code provisions without reference to their subsequent case law treatment may in certain situations aid in determining whether a cash advancement should be classified as a loan or an investment of capital, this technique is not appropriate for solving the problem presented in this case.

That we are not presented with a case of first impression is graphically demonstrated by *Byerlite Corp.* v. *Williams*, 286 F.2d 285 (6th Cir. 1960). This important case was heavily relied upon by the taxpayer, but is not mentioned in the majority opinion.

In *Byerlite* the Sixth Circuit held that advances made by the Byerlite Corporation to its subsidiary the Byerlite Export Company, Ltd., were loans rather than contributions to capital and therefore the taxpayer was entitled to deduct from its ordinary income as a worthless debt the loss of such loans. The situation there presented and the facts in case at bar are compellingly analogous. The only factual difference is that in *Byerlite* the Export Company was a wholly owned subsidiary of

the taxpayer whereas here NECCO was not a subsidiary of the taxpayer (although there was common stock ownership of the two corporations). In my opinion, this difference is without legal significance. In both cases, proper resolution of the tax question depends upon whether the taxpayer's expenditures were proximately related to his business activities. This court must decide whether the taxpayer's expenditure served a recognizable business purpose.

In the course of his opinion, Chief Judge McAllister in *Byerlite* said:

> On the books of Byerlite, the advances to Export were carried as accounts receivable; on Export's books, as accounts payable. This is the nomenclature of debt. Of course, the government is not bound in its tax collecting activities by the terminology used by a taxpayer if such terminology is used to disguise something quite different. However, if the stockholders of a corporation determine just how much of their funds they care to risk in the form of capital and how much, if any, they are willing to lend as a credit, and, when the venture is closed up, they take their loss as to such amount as they have loaned, and this leaves them in a position to enjoy more favorable deduction privileges than if they had put it all in as capital, this does not entitle the Commissioner of Internal Revenue to rewrite their balance sheet for them and show to be capital what was intended to be a loan. * * * The decisive factor is not what the payments are called but what, in fact, they are, and that depends upon the real intention of the parties. * * * The indicia relied upon by the government are not controlling. The fact that advancements to a corporation are made without requiring any evidence of indebtedness or fixing any date for repayment; without requiring the payment of any interest; and with the realization that the tangible assets of the corporation were not such, at any given time during the taxable period, as to repay any part

of the loan—was not a controlling consideration requiring a conclusion that the advances were not loans and that a deduction from ordinary income for a bad debt was not properly allowable, when the advances became uncollectible.

* * *

From the foregoing, it appears that losses of great sums of money resulting from large loans to corporations with slight capital, and even purchases of stock in corporations, are held not to be investments in capital, where the intent to invest was not present and where the funds were loaned, or stock purchased, only to promote the business purposes of the stock purchaser or lender. (footnotes omitted.) 286 F.2d at 290-291.

There, as here, the Government argued that the advances made by the taxpayer constituted contributions of capital and attempted to support the argument by indulging in various fictions unsupported by the realities of the situation. Judge McAllister's response to the Government's contention is squarely applicable in this case:

In arguing that appellant is not entitled to a bad debt deduction, the government is obliged to contend, as the District Court found, that Byerlite's advances to Export were not loans but were an investment in Export's capital stock. Such a contention is based upon a theory that seems most unreal and artificial. Export had no need to sell stock, and Byerlite had no need to purchase stock to carry out the contemplated operations. To deprive Byerlite of a deduction for a bad debt on the ground that it was investing in Export's stocks, rather than loaning money to Export, would seem to require a complicated, unreal, artificial assumption to be substituted for an ordinary, normal, and regular method of doing business, which, in this case, was characterized by the absence of any motive to operate otherwise than as shown by

the records of the two companies, and with no hint of subterfuge or attempt to evade simple, straightforward business practices — and certainly, with no thought of advantage in manner of operation, or as to tax consequences. 286 F.2d at 292.

One of the fictions suggested by the Government to support its theory that the advances to NECCO were contributions to capital rather than loans is that the taxpayer was actually a shareholder in NECCO and that the debt carried on the taxpayer's books was in reality an investment. That the Government's position is illogical can be demonstrated by hypothesis. If NECCO had been a successful operation and not only repaid the taxpayer's cash advances but also generated a profit, this profit, would have been distributed not to the taxpayer, but to NECCO's stockholders. The taxpayer would have had no claim to such profit. Under such circumstances would the Government have attempted to tax such profit to the taxpayer? To ask the question is to answer it.

I would reverse the judgment of the district court.

APPENDIX C

OPINION OF THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF ILLINOIS

The Honorable Bernard M. Decker, Judge Presiding

[279 F.Supp. 592]

MEMORANDUM OPINION

This is an action arising under 28 U.S.C. §1346(a)(1) for recovery of federal income taxes alleged to have been illegally assessed and collected. Plaintiff is a Delaware corporation engaged primarily in the construction of gas distribution facilities. At issue is the disallowance by the District Director of Internal Revenue of a "bad debt" deduction claimed by plaintiff in its federal income tax return for the 1956 fiscal year, that is, the year ending March 31, 1956. Plaintiff's claimed "bad debt" was the result of the inability of a company set up by plaintiff's sole stockholder and one of its officers to repay the major portion of monetary advances from plaintiff. Plaintiff claims that the advances were and should be regarded as loans, and the Government considers them to have been contributions to capital. Plaintiff thus asserts that the unpaid balance of the advances was deductible in full as a bad debt, while the Government argues that it was deductible only as a long-term capital loss to be offset against capital gains, of which plaintiff had none in this case.

The facts have been stipulated by the parties. Basically they are as follows: Plaintiff was incorporated in Delaware in 1949 under the name Consolidated Gas and Service Company. Its capital stock was owned entirely by John C. Donnelly, and its business was construction of gas distribution facilities. In 1954 a separate company, Northeastern Electric Construction Corporation (henceforth "Northeastern") was created, with Donnelly and

Arthur Schmidt, an officer of plaintiff, as stockholders. Northeastern was set up to undertake electrical construction work for one of plaintiff's most important customers. The separate corporate entity was considered necessary because of certain rules of the electrical workers union which prevented the workers from being employed by companies not doing electrical work exclusively.

The initial capital of Northeastern was about $12,000. From the end of 1954 to March, 1956 plaintiff made advances of over $300,000 to or on behalf of Northeastern primarily for operating expenses. These advances were carried as accounts receivable by plaintiff, and no written evidences of indebtedness were given, no interest or maturity date was agreed upon, and no security was provided. Despite the advances, Northeastern incurred serious losses from its inception. In March, 1956 it was decided to merge the two companies into one, the present plaintiff known as Northeastern Consolidated Company.

The merger was undertaken as a statutory merger under Delaware law and included a transfer of Northeastern's assets to plaintiff. Plaintiff's advances to Northeastern were left unreimbursed after the transfer in the amount of $199,791.09. This amount, the remainder of what plaintiff characterizes as the total "debt," was cancelled on plaintiff's books; plaintiff then claimed it as a worthless debt and deducted it from taxable income for the year ending March 31, 1956. The Internal Revenue Service first allowed the deduction, including the carryback of plaintiff's resultant 1956 net operating loss to 1955 and 1954, but then the Service subsequently disallowed it and assessed a deficiency. Plaintiff paid the deficiency and unsuccessfully filed claims for refund. Those claims were denied, and plaintiff now seeks a refund through this suit.

As part of the merger effected in 1956, Northeastern's own net operating loss, which totaled about $187,000 at the time of the merger, was made available to plaintiff to be offset against its taxable income under the pro-

visions of 26 U.S.C. §381(a) and (c). Plaintiff claimed and was allowed deductions by virtue of this for 1959, 1960, and 1961, in an aggregate amount of about $85,000.

Although plaintiff's complaint in this case seeks recovery of substantial amounts for 1954, 1955, and 1956, plaintiff now concedes that the stipulations and briefs show that plaintiff's possible recovery is limited to the following:

1954	$ 10.75
1955	56,784.95
1956	0

Plaintiff also seeks the amounts of interest made applicable by statute if it should recover. The above amount of $10.75 for 1954 is what remains after the effects of the statute of limitations for that year are recognized. The original amount for 1955 was reduced, and the amount for 1956 eliminated, by refund payments already made to plaintiff for those years on grounds distinct from those asserted by plaintiff at present. Although nothing is now sought to be recovered for 1956, the central issue in the case is, nevertheless, the bad debt deduction claimed for that year, with its carryback effects to 1955 and 1954.

The Government's assertion that the advances in question were contributions to capital, rather than loans, must be considered first, for if it is meritorious, there is no need to consider the other arguments raised by the parties. It is clear in this Circuit that the burden is upon the taxpayer in a case such as this to prove that the advances were loans rather than capital contributions. In *Arlington Park Jockey Club, Inc.* v. *Sauber,* 262 F.2d 902 (7th Cir. 1959), the court said,

> "In determining whether the cash payments . . . represented loans or additional capital investment, no single test can provide the answer. The burden of establishing that the advances were loans is upon the taxpayers." [Citations omitted.] *Id.* at 905.

There are many cases such as this which indicate that the taxpayer has the burden of proving that he is entitled to a bad debt deduction. *U.S.* v. *Henderson,* 375 F.2d 36 (5th Cir. 1967); *Moughon* v. *Commissioner,* 329 F.2d 399 (6th Cir. 1964); *Baumann & Co.* v. *Commissioner,* 312 F.2d 557 (2d Cir. 1963); *Bair* v. *Commissioner,* 199 F.2d 589 (2d Cir. 1952).

The cases also make it clear that where closely held corporations are involved, each element of the dealings between them will be closely scrutinized to determine whether advances made by one to the other are to be treated as loans. As was summarized in *Arlington Park Jockey Club,*

> "the courts have laid down rather stringent tests to determine whether advances to closely held corporations may be treated as loans for tax purposes. This court said in *Commissioner of Internal Revenue* v. *Meridian & Thirteenth Realty Co.,* 7 Cir., 132 F.2d 182, 186 [1942]:
>
> > '* * * the essential difference between a creditor and a stockholder is that the latter intends to make an investment and take the risks of the venture, while the former seeks a definite obligation, payable in any event.'
>
> "In such cases, courts have stressed various factors such as the debt-equity ratio; the use to which the funds were put; whether outside investors would make such advances and lack of reasonable expectation of repayment." *Id.* at 905.

Very similar statements appear in *U.S.* v. *Henderson, supra,* and *Moughon* v. *Commissioner, supra.*

While realizing that the factual elements establishing a bona fide debt may vary in different cases, the courts and the tax authorities nevertheless have attempted to formulate and adhere to a general definition. In order for plaintiff to carry his burden in the present case, it must show that the advances it made to Northeastern

fall within the definition. As indicated in the quotation above, the Court of Appeals for the Seventh Circuit early stated that a loan essentially involves "a definite obligation, payable in any event." In a more recent decision, that court referred to "the classic criteria of a bona fide debt set out in *Gilbert* v. *Commissioner*, 248 F.2d 399 (2d Cir. 1957)." *Sherwood Memorial Gardens* v. *Commissioner*, 350 F.2d 225, 228 (7th Cir. 1965). In *Gilbert*, it was said,

> "The classic debt is an unqualified obligation to pay a sum certain at a reasonably close fixed maturity date along with a fixed percentage in interest payable regardless of the debtor's income or lack thereof. While some variation from this formula is not fatal to the taxpayer's effort to have the advance treated as a debt for tax purposes, too great a variation will of course preclude such treatment." (Citations omitted.) 248 F.2d 402-03.

The essence of a debt for tax purposes has been more succinctly characterized in this way:

> "The important underlying principle is that no valid debt exists unless there is an unconditional obligation of another to pay the taxpayer." 5 Mertens, Law of Federal Income Taxation §30.03. See Treas. Reg. §1.166-1(c) (1967).

These statements indicate that the various aspects of the advances made by plaintiff must be examined here in detail in order to see whether they constituted an unconditional obligation upon Northeastern to repay the amounts obtained from plaintiff.

On the facts before me I cannot find that plaintiff has proved the existence of such an obligation. In a number of respects it appears clear to me that the intention of plaintiff, and the practical, business significance of the advances, demonstrate that the advances were contributions to the capital of Northeastern. First of all, the heavy preponderance of "debt" to equity in the financial

structure of Northeastern during its brief existence suggests that the advances were not regarded by plaintiff as loans and should not be considered as such now. This preponderance is not determinative, but it does seem that with operating capital of only $12,000, the advances of over $300,000 which were used for operating expenses were necessary capital of the sort ordinarily provided by the creation of equity interests. Further suggesting this is, of course, the absence of any provisions for interest, fixed maturity, or security in relation to the advances. The only relevant formalities gone into were entry of the advances as accounts payable on Northeastern's books and as accounts receivable on plaintiff's.

Additionally it seems evident that the repayment of the advances rested solely upon the success of Northeastern's venture. There apparently were no other resources of significant size held by Northeastern out of which plaintiff could have secured repayment had the venture failed, and this apparently was evident to all parties at the outset. That this consideration, and the preponderance of debt over equity, can be taken as indicative of an intention that the advances were to be capital investments rather than loans is suggested by the discussion in *American Processing and Sales Company* v. *U.S.*, 371 F.2d 842 (Ct. Cl. 1967). That case is relied upon strongly by plaintiff here, but it is not persuasive authority in its favor. The Court of Claims in that case plainly takes the approach, which I have already discussed, of considering each case on its own facts:

> "[I]n the final analysis each case must rest and be decided upon its own unique factual flavor, dissimilar from all others, for the intention to create a debt is a compound of many diverse external elements pointing in the end to what is essentially a subjective conclusion." *Id.* at 848.

The court also adopts the type of general definition of debt which I have examined. The opinion discusses a number of cases related to the questions in the present

case and concludes that the advances there involved were loans and not contributions to capital, "as a matter of substantial economic reality." That reality is lacking here.

It seems to me that in *American Processing* and in the other case plaintiff chiefly relies upon, *Byerlite Corporation* v. *Williams*, 286 F.2d 285 (6th Cir. 1960), the courts are taking a pragmatic view of the business transactions involved and are concluding that bona fide lending does take place when there are open account advances and "credits against the advances [are] made in the form of delivered materials." 371 F.2d at 855. In other words, each of those cases relates to an instance in which "the open account . . . was the product of credits and debits resulting from mutually advantageous trading." *Id.* at 854. The present case does not involve this common form of mutually offsetting business dealings based on continuing credit and intermittent, but assured repayment. The court in *American Processing* explicitly recognized that the result on the facts before it probably had to be different from the result in a case like the present one. The court said that a debit balance resulting from mutually advantageous trading activities,

> "assumes a different complexion than had it been solely cash advances, for the latter would be more amenable to construction as capital contributions." *Id.*

The present case, of course, involves "solely cash advances," with no repayment, credits, or reciprocal trade dealings at all.

In further support of the Government's contention that the advances were risk capital are the plaintiff's repeated assertions in its briefs that the activities of Northeastern were really parts of plaintiff's own business, and that they were not a separate corporate venture. Plaintiff apparently has made and reiterated this point in order to indicate that there was no intention present to invest in a *separate* venture, that is, in the risks of a

new corporate enterprise. A more significant effect of plaintiff's argument, however, is that the advances to Northeastern in fact were considered additional investments in plaintiff's *own* business, or at least in a new branch of it, with all the same risks attendant upon the stockholder's and officers' investment of capital and effort in plaintiff itself. As one of plaintiff's officers indicated in his deposition, the understanding was that the advances would be repaid out of profits made by Northeastern at a future time. This is more plausibly the attitude of an investor than of a lender.

As one further consideration, it may be asked whether Northeastern could have obtained cash in the amount of $300,000 in total from any other sources on the same sort of terms, or absence of terms, as it received from plaintiff. I think it is highly unlikely that that could have been done, especially after it apparently was clear within a few months that Northeastern was not making money.

On the basis of these various factual considerations, it is my conclusion that no bona fide debt was created by plaintiff when it made the advances to Northeastern, but rather plaintiff was contributing to the capital of Northeastern. Consequently, plaintiff was not entitled to a bad debt deduction for 1956.

Plaintiff urges, however, that even if the deduction was not allowable as a bad debt under §166, it nevertheless was allowable as a business expense under §162. This argument is without merit inasmuch as plaintiff was definitely not in the business of making advances to other companies. Plaintiff, as a separate corporate taxpayer, was not even in the business of constructing electrical facilities, as is indicated by the fact that the actual operating expenses incurred through use of the advances were deducted by Northeastern as its own expenses and not by plaintiff. Plaintiff has not met the burden it assumed of proving that the advances were ordinary and necessary business expenses. See *Interstate Transit Lines* v. *Commissioner,* 319 U.S. 590 (1943).

Plaintiff's final argument is that it is entitled to the deduction as a business loss by virtue of §165 of the Internal Revenue Code. This argument also is not persuasive. In the first place, it is not clear that plaintiff's failure to obtain reimbursement of the advances constitutes a "loss" within the meaning of §165. Rather it appears that plaintiff has experienced a "failure of profit or the loss of potential income" on its investment in Northeastern. 5 Mertens, Law of Federal Income Taxation §28.12, p. 33. If this is so, plaintiff is not entitled to any sort of benefit at all from §165. Secondly, whatever actual loss has been suffered by plaintiff can be considered a capital loss. It is true that no "sale or exchange" appears to have taken place with regard to plaintiff's unreimbursed interest in Northeastern; nevertheless, under the terms of §165(g) plaintiff's "loss" can receive only the treatment accorded a capital loss. This result is compelled by the case of *Phil Kalech* v. *Commissioner*, 23 T.C. 672 (1955), in which a taxpayer's advances to a corporation were held to be capital contributions rather than loans. See 5 Mertens, *id.* at §28.38, p. 159. Section 165(g) now provides that any loss that results when a security which is a capital asset becomes worthless shall be treated as a loss from a "sale or exchange" of a capital asset. In *Kalech* the court considered the predecessor to §165(g) and said, "Securities, as defined by that section, include not only actual shares of a corporation but the 'rights to subscribe for or to receive such shares,' which is what petitioner here had by virtue of his advances to the corporation." *Id.* at 681. The present definition of "securities" includes a similar reference to "a right to subscribe for, or to receive, a share of stock in a corporation. This would seem applicable, by the reasoning in *Kalech*, to the plaintiff's interest in Northeastern as a result of its capital investment by means of the advances. Thus the only possible loss deduction available for plaintiff would be a long term capital loss, which would not entitle it to a refund in the present case.

As an additional, alternative ground for the decision of this case, it must be said that plaintiff is attempting here to obtain to some extent double deductions for a single economic loss. As I have already noted, plaintiff was allowed to benefit from Northeastern's net operating loss; plaintiff took deductions aggregating approximately $85,000 in its tax returns for 1959, 1960 and 1961 in this respect. The case of *Marwais Steel Company* v. *Commissioner*, 354 F.2d 997 (9th Cir. 1965), cited by the Government, clearly indicates that double deductions in a case such as this will not be permitted.

The Government does acknowledge that plaintiff only got $85,000 worth of deductions by reason of Northeastern's net operating loss of over $187,000. Plaintiff contends that this discrepancy nullifies the double deductions argument. In answer the Government presents what appears to be a theory that the plaintiff has made some sort of implied waiver of the various deduction arguments it now makes. The Government says, "The point is that the net operating loss carryover was the one claimed by the plaintiff." I am not convinced that this waiver conception is correct, but it is in any event not necessary for me to decide the point now. The plaintiff has failed to show that it is entitled to the 1956 deduction and the carrybacks on any ground; consequently it is entitled to no refund at all. If plaintiff had shown some basis for refund, perhaps the double deductions argument would require a scaling down of the recovery, even if not a total preclusion of recovery. On the facts before me, however, I find that no refunds at all are justified.

For the foregoing reasons, I have on this day entered judgment in favor of the defendant and against the plaintiff, with costs to be assessed against the plaintiff.

ENTER:

/s/ Bernard M. Decker
United States District Judge.

Dated: November 30, 1967.

APPENDIX D

STATUTES INVOLVED

INTERNAL REVENUE CODE OF 1954
TITLE 26 U.S.C.

Sec. 162. Trade or Business Expenses.

(a) In General. — There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.

• • •

Sec. 165. Losses.

(a) General Rule. — There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(b) Amount of Deduction. — For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in Section 1011 for determining the loss from the sale or other disposition of property.

• • •

(f) Capital Losses. — Losses from sales or exchanges of capital assets shall be allowed only to the extent allowed in Sections 1211 and 1212.

• • •

(g) Worthless Securities. —

(1) General Rule. — If any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall, for purposes of this subtitle, be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.

(2) Security Defined.—For purposes of this subsection, the term "security" means—

(A) A share of stock in a corporation;

(B) A right to subscribe for, or to receive, a share of stock in a corporation; or

(C) A bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form.

(3) Securities in Affiliated Corporation.—For purposes of paragraph (1), any security in a corporation affiliated with a Taxpayer which is a domestic corporation shall not be treated as a capital asset. For purposes of the preceding sentence, a corporation shall be treated as affiliated with the Taxpayer only if—

(A) At least 95% of each class of its stock is owned directly by the Taxpayer, and

(B) More than 90% of the aggregate of its gross receipts for all taxable years has been from sources other than royalties, rents (except rents derived from rental of properties to employees of the corporation in the ordinary course of its operating business), dividends, interest (except interest received on deferred purchase price of operating assets sold), annuities, and gains from sales or exchanges of stocks and securities.

In computing gross receipts for purposes of the preceding sentence, gross receipts from sales or exchanges of stocks and securities

shall be taken into account only to the extent of gains therefrom.

• • •

Sec. 166. Bad Debts.

(a) General Rule. —

(1) Wholly worthless debts. — There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) Partially worthless debts. — When satisfied that a debt is recoverable only in part, the Secretary or his delegate may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

(a) Amount of Deduction. — For purposes of subsection (a), the basis for determining the amount of the deduction for bad debt shall be the adjusted basis provided in Section 1011 for determining the loss from the sale or other disposition of property.

• • •

Sec. 1011. Adjusted Basis for Determining Gain or Loss. The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under Section 1012 or other applicable sections of this subchapter and subchapters C • • •, K • • •, and P (relating to capital gains and losses), adjusted as provided in Section 1016.

• • •

[Subchapter P]

Sec. 1012. Basis of Property — Cost.

The basis of property shall be the cost of such property • • •."

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In the Supreme Court of the United States

OCTOBER TERM, 1968

No. 1382

NORTHEASTERN CONSOLIDATED COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the district court (Pet. 10a–19a) is reported at 279 F. Supp. 592. The opinion of the court of appeals (Pet. 1a–9a) is reported at 406 F. 2d 76.

JURISDICTION

The judgment of the court of appeals was entered on January 6, 1969. The petition for rehearing was denied on February 17, 1969. The petition for a writ of certiorari was filed on May 10, 1969. The jurisdiction of the Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the courts below properly characterized advances petitioner made to a corporation controlled by its sole shareholder as contributions to capital so that the resulting loss was a capital loss rather than a bad debt.

STATUTE INVOLVED

Sections 165 and 166 of the Internal Revenue Code of 1954 are set forth in the petition (Pet. 20a–22a).

STATEMENT

Petitioner is a Delaware corporation which was organized in 1949 under the name Consolidated Gas and Service Company. Its operations involved the construction of gas distribution facilities. John C. Donnelly owned all the capital stock. (Pet. 10a.)

In 1954, a separate company, Northeastern Electric Construction Corporation (Necco), was organized to engage in electrical construction work for one of the petitioner's most important customers. Donnelly and Arthur Schmidt, an officer of petitioner, were the stockholders. A separate corporate entity was used to conform to rules of the International Brotherhood of Electrical Workers, which would contract only with companies doing exclusively electrical work. (Pet. 10a–11a.)

Necco's initial capital was about $12,000. From the end of 1954 to March 1956, Delaware Consolidated advanced over $300,000 to or on behalf of Necco, primarily for operating expenses such as payrolls, materials and overhead. Although petitioner carried the advances as accounts receivable, no written evidences of indebtedness were given, no interest or

maturity date was agreed upon, and no security was provided." (Pet. 11a.)

Necco incurred serious losses from its inception. In March 1956, it was decided to merge the two companies into one, the present petitioner, with a transfer of Necco's assets to petitioner. There is no evidence of any payments or credits against the advances up to the time of the merger. As part of the merger the value of Necco's properties were applied against the advances. The amount left unreimbursed—$199,791.09—was cancelled on petitioner's books of account. (Pet. 11a.)

Petitioner claimed a bad debt deduction for the $199,791.09, for its taxable year ending March 31, 1956. The Commissioner of Internal Revenue first allowed the deduction, including the carry-back of petitioner's resultant 1956 net operating loss to 1954 and 1955, but subsequently disallowed it and assessed deficiencies.[1] Petitioner paid the deficiencies and filed claims for refund. The claims were denied by the Commissioner and petitioner filed this suit in the district court. (Pet. 11a.) That court rendered judgment for the government (Pet. 19a). The court of appeals, one judge dissenting, affirmed (Pet. 1a–9a).

[1] As part of the merger effected in 1956, Necco's own net operating loss, which totalled about $187,000 at the time of merger, was made available to petitioner as an offset against its taxable income. Petitioner claimed and was allowed carry-over deductions for 1959, 1960 and 1961 aggregating approximately $85,000. (Pet. 11a–12a.)

ARGUMENT

The decision below is correct and there is no conflict of decision that calls for further review.

1. To justify a business bad debt deduction under Section 166 of the Internal Revenue Code of 1954, a taxpayer must first demonstrate that a true indebtedness existed. Petitioner's advances to Necco must be characterized as debt or capital investment according to the substance, rather than the form, of what occurred. *Higgins* v. *Smith,* 308 U.S. 473, 477. The underlying determinant is that an investor's prospects of return are contingent upon the successful operation of the corporate venture, while the lender's are not. In any particular case a variety of factors must be evaluated in the light of this underlying distinction. The pertinent criteria were most recently summarized thusly (*Berkowitz* v. *United States,* 69–1 CCH Tax Cases ¶ 9398, at p. 84,636 (C.A. 5)):

> There are at least eleven separate determining factors generally used by the courts in determining whether amounts advanced to a corporation constitute equity capital or indebtedness. They are (1) the names given to the certificates evidencing the indebtedness; (2) the presence or absence of a maturity date; (3) the source of the payments; (4) the right to enforce the payment of principal and interest; (5) participation in management; (6) a status equal to or inferior to that of regular corporate creditors; (7) the intent of the parties; (8) "thin" or adequate capitalization; (9) identity of interest between creditor and stock-

holder; (10) payment of interest only out of "dividend" money; (11) the ability of the corporation to obtain loans from outside lending institutions.

The circuits generally agree. See, *e.g.*, *Gilbert* v. *Commissioner*, 248 F. 2d 399 (C.A. 2); *Fin Hay Realty Co.* v. *United States*, 398 F. 2d 694 (C.A. 3); *Wood Preserving Corp. of Baltimore* v. *United States*, 347 F. 2d 117 (C.A. 4); *Tomlinson* v. *1661 Corp.*, 377 F. 2d 291 (C.A. 5); *Moughon* v. *Commissioner*, 329 F. 2d 399 (C.A. 6); *Burr Oaks Corp.* v. *Commissioner*, 365 F. 2d 24, 27 (C.A. 7); *Taft* v. *United States*, 314 F. 2d 620 (C.A. 9); *Covey Investment Co.* v. *United States*, 377 F. 2d 403 (C.A. 10).

As the majority opinion below recognized (Pet. App. 3a), analysis of these factors in this case militates against the conclusion that a *bona fide* debt existed. Necco was thinly capitalized, repayment was contingent on Necco's success, Necco and petitioner had some identity of interest, and comparable outside lending was unavailable. Only the nomenclature the parties used to describe the transaction supports petitioner's claim that a debt existed, and that fact alone cannot overcome the significant indications of a capital contribution shown in this record.

2. There is not, as petitioner argues (Pet. 12–13), a present conflict between the decision here and the position of the Sixth Circuit evidenced in *Byerlite Corp.* v. *Williams*, 286 F. 2d 285, and the Court of Claims decision in *American Processing & Sales Co.* v. *United States*, 371 F. 2d 842. There are similarities

between the instant case and those cases, but the considerable amount of litigation in this area shows a multitude of variations depending upon the facts of each case. The decision in each instance must rest on a balancing of the relative weight of a mixture of facts which seldom present themselves again in the same proportion. The result is that square precedent is rarely encountered. See Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders* (2d ed.) Sec. 4.02, p. 122. Certiorari should be granted to resolve a conflict, we suggest, only in those instances where the lower courts have disagreed as to the characterization to be given virtually identical factual patterns or where a court, in disagreement with the decisions cited at pp. 4–5, *supra,* holds that one of the enumerated factors either should be given no weight or should be considered dispositive.

Neither of these suggested criteria would justify review of this case. As the Court of Claims noted in *American Processing, supra,* 371 F. 2d at 855, both there and in *Byerlite* credits were made against the advances in the form of delivered materials. In each case, the credits indicated that, in economic substance, the advances were treated as loans by the "borrower", thus suggesting the parties intended that the advances would be repaid. No such evidence appears in the instant case.[2]

[2] There is no inconsistency (see Pet. 17) in the government's arguments respecting Section 165(g)(3) of the Internal Revenue Code of 1954. Section 165(g)(3) provides in relevant part that any security of a corporation affiliated with the taxpayer shall not be treated as a capital asset. This statute fails to apply

It is true that language in *Byerlite* suggests that the parties' nomenclature and purported intent to create a debt controlled, without regard to the presence of other factors indicating the existence of a capital investment. But this does not provide an adequate basis for a grant of certiorari, since intervening developments indicate that *Byerlite* no longer expresses the position of the Sixth Circuit. In *Moughon* v. *Commissioner,* 329 F. 2d 399, and *Foresun, Inc.* v. *Commissioner,* 348 F. 2d 1006, the Sixth Circuit had occasion to review the debt-equity issue anew. In both cases, the court adopted the generally accepted objective criteria for resolution of the debt-equity issue. See pp. 4–5, *supra.* It avoided any reference to *Byerlite* in either opinion, which led Chief Judge Thomsen in *Wood Preserving Corp. of Baltimore* v. *United States,* 233 F. Supp. 600 (D. Md.), affirmed, 347 F. 2d 117 (C.A. 4), to observe (233 F. Supp. at 605) that the *Byerlite* decision "has been considerably weakened by Moughon". There has been no countervailing indication that at the present time *Byerlite* is of controlling significance in the Sixth Circuit. Rather, it appears that *Byerlite* is to be lim-

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here for two independent reasons: first, Necco does not qualify as an affiliated corporation, since (see Section 165(g)(3)(A)), petitioner did not own at least 95 percent of each class of Necco's stock; and, second, because its investment in Necco did not, in the statutory sense, become "worthless," but was merely impaired to the extent of the loss occasioned by the subsequent merger of Necco with petitioner. Petitioner never questions either of these facts.

ited to its own facts, even in its own circuit.[3] Any thought that the Court of Claims, in its reliance on *Byerlite,* has ventured an approach different from or in conflict with that taken in the circuits is put to rest by the following passage in *American Processing* (371 F. 2d at 848):

> There is no dearth of cases in this province of tax law. So large is their number and disparate their facts, that for every parallel found, a qualification hides in the thicket. At most they offer tentative clues to what is debt and what is equity for tax purposes; but in the final analysis each case must rest and be decided upon its own unique factual flavor, dissimilar from all others, for the intention to create a debt is a compound of many diverse external elements pointing in the end to what is essentially a subjective conclusion. Elsewhere these elements have included such criteria as the "real intention" or "true intention" of the parties as expressed in the instrument of debt and corroborated by surrounding facts; ratio of debt to equity in the financial structure of the debtor (i.e., the "thin incorporation" line of decisions which enjoyed a decade of popularity); reasonable expectation of repayment regardless of the success of the venture; substantial economic reality of the transaction; and maintenance of proportional

[3] Subjective intent or motivation should not have the significance *Byerlite* attaches to it. A taxpayer's allegations of what it thought it was doing, or meant to do, have at most marginal relevance in determining what it in fact did do. See, *e.g., Tomlinson* v. *1661 Corp., supra,* 377 F. 2d at 299; cf. *Knetsch* v. *United States,* 364 U.S. 361, 365; *United States* v. *Estate of Grace,* No. 574, O.T., 1968, decided June 2, 1969.

holdings by stockholders whose purported loans remain in suspicious balance with their capital contributions.

3. Nor is there a conflict with this Court's decision in *Corn Products Refining Co.* v. *Commissioner*, 350 U.S. 46, or any of the various court of appeals decisions cited at pp. 14–17 of the petition. Those cases do not remotely suggest, as petitioner would apparently have it, that securities owned by a corporate taxpayer are generally non-capital assets. Rather the cases are exceptions to the general rule that a "security" investment in a corporate[4] is a capital asset, and rests on special factual contexts which in no way resemble the instant case.

In *Corn Products*, the Court was asked to decide whether the taxpayer, a manufacturer of corn by-products, was entitled to capital gains treatment on its profit from dealing in corn futures. The decision that the profits were ordinary income proceeded from the fact that the taxpayer's "long position" in corn futures was established "'as a part of its corn buying

[4] Although it is unquestioned that the definition of a capital asset must be narrowly construed, a corporate security is generally a capital asset because it represents investment in a corporate venture placed at the risk of the enterprise over an indefinite future, except in certain very special situations. Section 165 of the Code, among others, supports this premise, since it is only by express exception (Section 165(g)(3)) that a worthless security is given ordinary loss treatment. See, also, Section 341 (collapsible corporations), Section 582 (securities held by a dealer), and Sections 1242 through 1244 (relating to small business investment companies and stock of small businesses). In contrast, no section affirmatively defines a special type of security to be a capital asset.

program' and 'as the most economical method of obtaining an adequate supply of raw corn' " (350 U.S. at 48) and that it therefore constituted an integral part of its manufacturing business (350 U.S. at 51). In contrast, the operation of Necco, in the instant case, was not an integral part of petitioner's business, but was a separate and distinct field of endeavor which Donnelly decided to enter.

In each of the court of appeals decisions which petitioner cites, the expenditures either were undertaken to alleviate temporarily some impediment to the operation of the business, or were an integral part of a non-capital item, such as the acquisition of raw materials. In *Booth Newspapers, Inc.* v. *United States,* 303 F. 2d 916, 921 (St. Cl.), the taxpayers purchased stock in a paper manufacturing company, but only to insure a short term source of newsprint. In *Lutz* v. *Commissioner,* 282 F. 2d 614, 619 (C.A. 5), payments to creditors of the taxpayer's wholly owned corporation were necessary to retain an agricultural commodity brokerage license. In *United Gas Improvement Co.* v. *Commissioner,* 240 F. 2d 312 (C.A. 3), the taxpayer made short-term advances to a controlled subsidiary corporation to enable the subsidiary to meet its current dividend obligations. In *Five Star Manufacturing Co.* v. *Commissioner,* 355 F. 2d 724, 727 (C.A. 5), the holding of one shareholder was purchased in order to free the management from "unwarranted fetters". In *Commissioner* v. *Bagley & Sewall Co.,* 221 F. 2d 944, 947 (C.A. 2), the taxpayer had purchased government bonds

to guarantee performance of its purchase contract with a foreign corporation; and in substance the bonds served the function of a performance bond.[5]

Petitioner's sole shareholder, Donnelly, desired to enter the electrical contracting business. While this new venture in part permitted it to service an existing customer (Pet. 11a), the activity was an attempt to expand its operations permanently. Petitioner's advances represented capital placed at the risk of Necco's operations over an indefinite time in the future, and there is no precedent for allowing an ordinary loss deduction upon the unprofitable termination of Necco's operations.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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[5] In *Daily Journal Co.* v. *Commissioner*, 135 F. 2d 687, 688 (C.A. 9), the only question was whether salary paid to the taxpayer's president was reasonable in relation to the services performed.

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